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World Monetary System in the 1980s

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Following is an address by Richard N. Cooper, Under Secretary for Economic Affairs, before the National Foreign Trade Council in New York on October 21, 1980.

I am pleased and honored to have been asked to join the other participants in this convention to discuss issues vital to the development of international trade. Money, it is often said, is the lubricant of trade; the international monetary system is, then, the lubricating mechanism for international trade. The task of the international monetary system - as for a domestic monetary system - is to provide sufficient, but not excessive, liquidity to support a growing volume of trade and to distribute that liquidity to those who can use it effectively.

Liquidity represents access to funds on short notice to meet unexpected payments. Liquidity is made up of cash, assets that can be readily liquidated (liquidity thus depends intimately on the functioning of markets), and ready access to borrowing from either official or private sources. One can view the adequacy of liquidity either from the point of view of an individual country or from the point of view of the world as a whole. The latter perspective involves how well the system, as a whole, functions under strain. In 1931 it was the system of liquidity that collapsed, not merely the access of individual countries to funds.

The 150% increase in oil prices over the past 2 years has called for "unexpected payments" on an unprecedented scale and with a geographic scope foreshadowed only by the oil price increase in 1974. But the nature of the disturbance, a rise in oil prices, will also produce a sharp increase in revenues of oil-exporting countries, which will be available to the rest of the world. The external surplus of the Organization of Petroleum Exporting Countries (OPEC), amounting to $65 billion last year, will rise to over $110 billion this year and is projected to fall only slightly below $95 billion in 1981. So "liquidity" is not inadequate to the system as a whole. The problem is to get it around to the proper places on proper terms and conditions. This is called the "recycling" problem.

We encountered it once before in 1974 (the OPEC surplus in that year amounted to $67 billion). The more dire predictions about the consequences of the 1973–74 oil price increase did not come to pass, but we should not conclude from this that we got through that period unscathed. It is true that, contrary to some early predictions, private banks carried most of the recycling and with remarkable success. Private bank lending was supplemented in important ways by sharp increases in foreign assistance from OPEC countries and by a sharp increase in lending - some on special terms - by the International Monetary Fund (IMF). Moreover, the OPEC surplus declined more sharply than many observers expected, falling below $35 billion in 1975 and disappearing by 1978.

But we should also be reminded that 1974–76 saw the worst post-1930s reces-

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sion by far, that the oil price increase and policies that followed it gave inflation a sharp impetus around the world, and that many countries had such an accumulation of external debt (which process itself helped to cushion the recession) that their capacity to borrow further is sharply circumscribed, and we now face the need for numerous reschedulings.

We must not permit the qualified success of the 1974–78 period to make us complacent about the challenges of the 1980s. The situation we now face has several important features which make it different from and potentially more difficult than the last time around.

First, OPEC then experienced some erosion of its new financial position and in the future will take measures to prevent a recurrence of that erosion. OPEC's proposed pricing and production policy, if carried out, would mean continual price increases in real terms, an extended period of imbalances, and a continuing need to recycle funds from oil exporters to the rest of the world.

Second, a number of countries - developed and developing alike - financed their way through the difficulties of the 1970s and now find themselves in an exposed debt position with little or no progress made toward enhancing their ability to repay that debt.

Third, the private capital markets are starting from a significantly higher exposure, especially in less developed countries (LDCs) and may be unwilling to go much further without substantially larger spreads. Banking regulatory authorities in financial centers are becoming concerned, as bank capital has not fully kept pace with the expanded international lending.

Fourth, unacceptably high rates of inflation in most industrialized countries together with heightened government and public concern about inflation will mean that the developed countries as a group will grow at a moderate pace, providing a less buoyant market for LDCs.

Taking these features as a background, I would like to trace out several of the challenges the monetary system will face in the early 1980s.

Financing and Adjustment

To cope with this major shock to the world economy, we must be sure that adequate financing is made available. Not to do so would cause a major world depression and would require economic adjustment under extreme duress. But financing alone does not represent a solution to the shock of sharply higher oil prices. Our economies must adjust to this new reality. It will require substantial changes in the capital stock of all countries in the direction of conserving energy and utilizing fuels other than oil. The pervasive use of oil in most economies around the world implies that large portions of the world capital stock must ultimately be changed.

Thus, we need both financing and adjustment. The art of skillful economic management is to find the most judicious mixture between the two, to assure that adjustment takes place smoothly and efficiently, minimizing the inevitable hardship that must attend such substantial changes in our economies. Two implications of this judicious mixture are worth noting. First, while we must ultimately alter a large fraction of our capital stock and new investment must be provided to that end, financing to sustain consumption is not necessarily undesirable for a period of time. We must after all make future investments by using the existing capital stock, and that too often depends on the use of oil. Thus, in many instances financing for "consumption" (of oil) represents a vital investment in continuing production, which in turn is required to make the longer run changes that we need to make.

Second, balance-of-payments deficits are not necessarily undesirable, even for industrialized countries, at least for a period of time. Indeed, such deficits are globally necessary so long as OPEC is running substantial surpluses. Quite apart from global arithmetic, it is worth recalling that current account deficits entail importing goods and services from the rest of the world or, to put the same point another way, borrowing the excess savings of the OPEC countries. Such deficits may therefore represent a desirable allocation of the world's savings to help revamp the existing capital stock along the required lines.

But how is the required adjustment to be assured? Adjustment is neither painless nor costless. In the short run, adjustment is easier to avoid than to undertake; easier still when financing makes avoidance possible. I emphasize "in the short run" because financing cannot be a permanent solution. The serious problems now being faced by a number of developing countries are attributable in part to attempts to use financing to avoid adjustment. Debt, of itself, is not a burden but an opportunity. If borrowed resources are used to enhance productive capacity or export competitiveness, they service themselves. Financing and adjustment must go hand-in-hand.

The private capital markets, which provide the bulk of the financing, cannot alone be expected to insure that the funds they lend will be efficiently used. This is particularly true when private banks engage in balance-of-payments financing, although all lending to sovereign governments is in a sense fungible. Individual creditor governments are not much better placed to provide the kind of encouragement needed. U.S. policy has been to look to the International Monetary Fund (IMF) as the institution best placed to foster, encourage, and support adjustment programs in its member countries. To do so, the Fund requires that a country develop and implement an economic adjustment program as a condition for extensive access to IMF resources.

Conditionality

As a result of this "conditionality" the Fund has developed a reputation as on ogre, a heartless tyrant out to stifle the development prospects of many developing countries. This perception is not only false but dangerous. There must be an incentive to adjust, short of the brutal awakening when financing abruptly ends. The IMF, through access to its own resources and through its influence on the judgments of the private market, can provide the needed encouragement and incentive. To do so, the Fund must insist on "conditionality" and will remain, in the eyes of many, the "bad guy."

Conditionality is not, however, an unchanging set of requirements which all countries must meet in all economic circumstances. The required economic adjustment program should be appropriate both to the economic objectives and social system of the country concerned and to the global economic situation. Many commentators on the recent IMF annual meetings noted that conditionality would be reduced as a result of complaints by developing countries. My expectation is that IMF-supported programs will require conditions appropriate to the circumstances, not weaker conditions.

Indeed, the IMF has already moved in this direction. An examination of recent IMF programs would find that more attention is devoted to improving economic incentives and reducing disincentives. Traditional demand management variables such as the fiscal deficit, current account deficit, or money supply are still important, but where appropriate they have yielded to closer attention to the supply side of the economy.

Conditionality - that is, the adjustment program involved - must also recognize that no long-run purpose is served by starving the existing system of production of needed raw materials. In the short run, an energy-inefficient capital stock must be fed on expensive, probably imported, energy. In the short run, borrowing for consumption is not necessarily unwise. However, the adjustment process must assure that in the longer run the accumulated debt can be serviced from the earnings of the new productive structure.

Future Role of the IMF

To carry out its vital role in the recycling process, the IMF must not only be willing to lend on conditions appropriate to circumstances; it must be willing to lend enough to help facilitate the adjustment process, and it must lend on terms which are suitable to the circumstances. And to lend sufficient funds, the IMF must have adequate funds available.

At the annual meeting of the IMF's Board of Governors, new IMF lending policies were approved which substantially increase the amounts potentially available to each borrowing country. Under traditional practice, each country can borrow an amount equal to its quota at the IMF. Under special circumstances this limitation can be waived, and during the past year waivers have been increasingly used. Recently the IMF formalized its new lending procedures, under which a member country can borrow up to twice its quota in any year, up to a cumulative total of six times its quota. This represents a very substantial increase in the amounts available to member countries. Moreover, the IMF agreed in principle to restrain the interest rates charged on funds borrowed under the supplementary financing facility by devoting repayments to the IMF trust fund, plus voluntary contributions, to bring interest rates down below market levels.

This substantial increase in potential IMF lending requires adequate availability of funds to the IMF. At present the IMF is well-endowed with funds, taking into account not only its general resources but also the supplementary finance facility of $10 billion negotiated in 1978. It has roughly $30 billion to work with, of which $5 billion is committed under unused stand-by agreements. But the magnitude of current and prospective deficits is such that IMF liquidity may well be strained a year or so from now. Several mechanisms are available for augmenting it. The first and most significant is the seventh quota increase, which calls for a 50% increase in quotas - and subscriptions - for all members of the Fund.

The Administration is working diligently to see to it that the last remaining legislative step is taken before year's end to permit U.S. participation in this quota increase and to bring these new resources into action. The quota increase, of course, will enlarge borrowing rights as well as funds available to the IMF. But in practical terms the latter effect will dominate the former, adding over $15 billion in usuable currencies. In addition, the IMF is investigating the possibilities for borrowing directly from countries with large external surpluses and it is also studying the possibilities for borrowing from private markets.

To improve effective international liquidity further, the Fund has also decided to modify the SDR [special drawing rights]. Beginning in 1981, the SDR will be simplified. A uniform five-currency basket will be used both in determining the value of the SDR and in calculating its interest rate. The IMF also plans to consider, at U.S. urging, bringing the SDR interest rate into line with market levels and eliminating some of the special requirements that presently limit its use. The success of efforts to promote the role of the SDR, as well as attitudes toward its allocation, will obviously be influenced by its yield and usability.

The conditions associated with IMF lending have already been discussed. Suffice it to say that major changes have already taken place, and that many critics of the IMF seem to be unaware of the rapid evolution in IMF practices under the very special circumstances that have prevailed in recent years. But conditions have been modified; they have not and cannot be eliminated. The IMF is not in the position of making grants to support income levels; rather it makes loans to facilitate adjustment. If the IMF did not play that role, we would have to find another mechanism in the international monetary system to perform it. So long as credit is limited, as it must be, somebody has to convey the unwelcome news. The IMF does that today, and on the whole it does it well.

One aspect of the IMF role has not developed as successfully as many had hoped. In the second amendment to the articles of agreement, the IMF was given the power - and indeed the obligation - to exercise surveillance over exchange rate policies and practices of its members. Surveillance covers countries in payments surplus as well as countries in deficit, but the IMF's influence over countries in overall surplus, particularly large industrialized countries, has always been a weak part of the international adjustment mechanism. To strengthen the surveillance process, the United States has proposed that countries with large imbalances submit to the IMF proposals for dealing with them, that the Fund assess the performance of individual countries in the context of an agreed global strategy, that it be agreed that the managing director should take the initiative in arranging more frequent consultations with members with large imbalances, and that more information on the prospective financing of imbalances be available. Whether surveillance can be strengthened to make it an effective tool of adjustment is still an open question.

Some kind of global surveillance is necessary to assure that the structure of imbalances is sustainable. To date the Fund has approached the task of surveillance cautiously.

Conclusion

In conclusion, I would like to pull together some of the major points I have endeavored to make and add a few.

First, the private market must perforce play the major role in handling the recycling problem, which will involve a large-scale transfer of funds from oil-exporting countries to oil-consuming countries for the next several years.

Second, private markets must be supplemented by official organizations and especially by the IMF. The IMF must have adequate funds to help countries on a scale and under conditions ap-

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propriate to today's circumstances. The World Bank, too, can play a useful supplementary role - partly through its new program for structural adjustment loans and over the longer term through a new energy facility which is currently under intensive study.

Third, more foreign aid will be needed, especially for the poorest countries, which have negligible access to private capital markets and whose capacity to adjust in the short run is severely limited. Under the circumstances, much of this additional aid must come from oil-exporting countries. In this respect the new Venezuelan-Mexican facility to assist countries of Central America and the Caribbean is an important step in the right direction.

Fourth, all oil-importing countries must take steps, including proper encouragement to the private sector, to reduce their dependence on imported oil. This is the adjustment that is most clearly required in the early 1980s. It will involve diverting scarce capital to revamp our capital stock to conserve energy, and it thus means higher costs. But such adjustment is necessary to avoid the still higher costs that will obtain if we fail. ■

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